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The economic background

The world economy

Overview

The most recent economic data suggests that the recovery is strengthening in the US and the Asian economies (excluding Japan) but is weaker in the Euro Area and Japan. Global domestic demand remains relatively weak but is expected to pick up in the second half of this year.

There are mixed signals from consumer confidence measures with some remaining weak while others are showing signs of improvement. The labour markets also demonstrate mixed performance. The unemployment rate fell in the US but so did the employment rate. Oil prices have remained flat but there is little evidence to suggest that the world economy is experiencing any significant inflationary pressures. There are clear signs however from central banks that interest rates will have to rise shortly. While the hostilities in Iraq were brought to a rapid conclusion there is now more concern over 'guerrilla warfare' from disaffected Iraqis and opposition groups. This is not only potentially destabilising for the Middle East but adds to the uncertainty in the world economy.

Outlook

We are still forecasting that the world economy will recover in the latter half of 2003 with full recovery in place in 2004. The US will lead this recovery but the non-Japan Asian economies will also contribute significantly to recovery. The recovery in the Euro Area has stalled and although we expect the Euro Area to pick up in the second half of 2003 it will not be fully in place in the Euro Area until 2004. Germany, Italy and the Netherlands are in recession but France remains marginally ahead of them. We also still expect imbalances in the world economy to narrow and that world trade will grow by 7 per cent in 2003.

Downside risks to the world economy

Despite the US and Asian economies driving the world economic recovery there are some concerns about this recovery. These are centred on the large US current account deficit (5.1 per cent of GDP in the first quarter of 2003). There are two scenarios: in the first rapid productivity gains in the US ICT sector could spread rapidly throughout the rest of the world. This would tend to increase global consumption and investment. Triggering a rise in interest rates, which would in turn slow US consumption and investment. In the second scenario US firms and consumers realise their expectations of productivity growth was over-optimistic and that they have accumulated more debt than future growth warrants. The resulting balance sheet adjustments lead to slower growth. The second scenario would probably lead to slower growth than the first. In both these scenarios the size of the US current account would reduce. There is little evidence for either yet but some signs include:

Æ US firms realise they have over-invested;
Æ consumer spending continues to be buoyant;
Æ productivity growth has not increased significantly in the rest of the world;
Æ an increase in the US fiscal deficit is offset by a decline in the financial deficit of the US private sector as a whole and
Æ the dollar has not fallen more sharply because of investors' persistence for dollar assets.

The first risk is that banks may decide they have enough dollar assets (e.g. learning the lesson of the Asian financial crisis) and the second risk is that there is a change in US households expectations of the growth of disposable income – particularly if employment continues to fall. So we cannot rule out a sharp decline in consumption. A pick-up in domestic demand elsewhere in the world however may be enough to offset these downside risks. This poses the question 'is the biggest risk our dependence on the US economy for recovery?'

United States

Real GDP growth was 0.6 per cent for 2003 Q2 on the previous quarter but this was better than expected although lower than the Bank of England forecast. This compares to 0.4 per cent in the first quarter of 2003. Annualised growth however is 3.1 per cent and this is better than expected. Real GDP is 2.3 per cent higher than it was in 2002 Q2. Financial markets have reacted well to the data. Our forecast for growth is 2.5 per cent in 2003 and 3.3 per cent in 2004.

Consumption grew by 0.8 per cent in the second quarter of 2003 compared to the previous quarter. Durable goods increased by 5.2 per cent in the same period. Retail sales rose by 0.5 per cent in June compared to no change in May. Government spending grew by 1.8 per cent for 2003 Q2 on the previous quarter. Most of this was due to the 9.6 per cent rise in Defence spending. Private investment rose by 1.6 per cent. Of this, residential investment rose by 1.5 per cent and non-residential investment increased by 1.7 per cent. This unanticipated increase in investment was welcome and taken as another sign that recovery is taking a firmer hold in the US economy. Net exports contributed -

Table 1: Forecasts of the main world economy indicators

				% Growth in real GDP					*Unemployment rate (%)*
		2002	*2003*	*2004*	*2005*	*2002*	*2003*	*2004*	*2005*
US		2.4	2.5	3.3	2.6	5.8	6.2	6.1	5.8
Japan		0.1	0.7	1.0	1.4	5.4	5.7	5.9	5.0
Euro zone	0.8	0.6	1.7	2.5	8.4	8.8	8.4	8.2	
Germany	0.2	0.0	1.3	2.5	8.6	9.0	8.9	8.2	
France		1.2	0.7	1.8	2.4	8.7	9.1	9.2	9.0
OECD		1.8	1.7	2.4	2.5	6.4	6.6	6.5	6.3

				Inflation rate (%)					*Short term interest rate (%)*
		2002	*2003*	*2004*	*2005*	*2002*	*2003*	*2004*	*2005*
US		1.4	2.1	2.9	2.8	1.7	1.1	1.4	2.1
Japan		-1.6	-0.9	-0.7	0.4	0.1	0.1	0.2	0.4
Euro zone	2.3	1.7	1.1	1.3	3.3	2.3	2.1	2.5	
Germany	1.4	0.8	0.5	0.9	n/a	n/a	n/a	n/a	
France		1.6	1.9	1.0	1.1	n/a	n/a	n/a	n/a
OECD		1.6	1.9	2.1	2.5	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices.

Sources: OECD Latest Release, www.oecd.org, the National Institute Economic Review, 185, July 2003 and the Bank of England Monetary Policy Committee Minutes, 6th and 7th August 2003.

0.4 per cent to GDP while inventories contributed –0.2 to GDP. Consumption contributed 0.6 per cent to GDP, with both government spending and investment contributing 0.3 per cent to GDP.

Again ICT output grew significantly at 1.0 per cent for the second quarter of 2003. Industrial production grew by 0.1 per cent in June (the same as May). Capacity utilisation remained unchanged at 74.3 per cent. The Institute of Supply Management manufacturing index increased from 49.8 in June to 51.9 in July and again to 54.9 in August. The non-manufacturing index climbed to 65.1 in July from 60.6 in June. This has now increased by 14 points in the last three months. The Conference Board index fell to 76.6 in July from 83.6 in June. The University of Michigan index of consumer confidence increased to 90.9 in July from 89.7 in June.

Headline CPI increased by 2.1 per cent in the year to July 2003 and was unchanged on June. Core inflation (excluding food and energy) fell to an annual rate of 1.5 per cent in June from 1.6 per cent in May and was unchanged in July. The annual US producer prices index growth is 3.0 per cent for up to July, up marginally from the 2.9 per cent up to June but a significant change from the 2.5 per cent up to May.

Non-farm payroll fell by 93,000 in August and this was unexpected. It also declined by 49,000 in July and by 72,000 in June. The unemployment rate however has declined from 6.4 per cent in June to 6.2 per cent in July and to 6.1 per cent in August. There was a sharp drop in the Labour Force in July. Non-farm payrolls have dropped for the sixth consecutive month and this is worrying. It is expected that there will be a lag in the labour market but concern is mounting that consumption and investment could be stalled if employment keeps falling and incomes decline.

Our outlook for the US economy is based several factors, the most encouraging of which is the increasing corporate profits growth. This is not due to cost –cutting and is stimulating investment. Further encouraging signs are the increased output of the ICT sector and the rise in price of silicon chips as well as the increased share prices of IT companies shares. The pace of growth in the second half of the year will depend upon consumer spending and if investment growth continues at its current rate. Tax cuts will be a further stimulus in the second half of the year.

Europe

Real GDP growth in the Euro Area was flat in the second quarter of 2003. Given it only increased by 0.1 per cent in the first quarter it is clear that the recovery in Europe has stalled. There is recession in Germany, Italy and the Netherlands with France only marginally ahead of them. French GDP declined by 0.3 per cent in 2003 Q2 after growth of 0.2 per cent in the first quarter. All the signs indicate however that the low point of the cycle has passed and that the expectation is for improvement in the second half of 2003 although any recovery will probably be export

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led. The recovery is likely to be gradual in 2003 with full recovery in Europe not apparent until 2004. Forward indicators are improving but output and employment data remain poor. We are forecasting growth for 2003 of 0.6 per cent in the Euro Area.

For 2003 Q1 consumption grew by 0.4 per cent and government spending increased by 0.3 per cent. Inventories rose by 0.5 per cent but investment fell by 1.2 per cent and net exports declined by 0.5 per cent. Growth of domestic demand in the first quarter of 2003 was 0.5 per cent. The outlook for domestic demand remains poor. Industrial production declined by 0.9 per cent in May compared to an increase of 0.4 per cent in April. Retail sales increased by 1.6 per cent in April but declined by 0.6 per cent in May and car registrations were up strongly in June, an increase of 5.2 per cent on May. Industrial production declined by 0.5 per cent in Germany in May and by 1.4 per cent in France (for the same period). Tourism is suffering the after-effects of the Iraqi conflict with a significant number of cancellations. There are few encouraging indicators at the moment in the Euro Area.

The ECB reduced interest rates to 2.0 per cent in June. HICP was 2.0 per cent in June and increased marginally from 1.9 per cent in May. It has fallen back to 1.9 per cent in July. Annual core inflation (excluding food, alcohol, energy and tobacco) declined to 1.6 per cent in July from 1.8 per cent in June. Producer prices index was 1.4 per cent in June, unchanged on the previous month. The Euro hit a four month low in August and has been under pressure from the dollar. French tax cuts are being brought forward to 2004 in order to try to provide a stimulus to the economy.

The Purchasing Managers Index for services increased from 48.2 in June to 50.2 in July. The same index for manufacturing also increased from 46.6 in June to 48.0 in July – at least a step in the right direction. The European Commission measure of business confidence in June was –13 and fell to –15 in July. The ifo business climate index climbed to 89.2 in July from 88.2 in June. August saw a further rise in this index, the fourth successive increase.

Unemployment was 8.9 per cent in June and was the same the previous month. This is 0.5 percentage points higher than 2002 Q2. Unemployment remains high in Germany at 9.4 per cent and in France at 9.6 per cent.

Japan

Real GDP growth in Japan was 0.6 per cent in 2003 Q2. This is the sixth consecutive quarter of positive growth. Japanese growth is forecast to be just below 1 per cent in 2003. Share prices have increased substantially as corporate profits are improving. Recovery in Japan is largely dependent on the growth of the US ICT sector. Other Asian economies appear to be growing well. We are forecasting growth of 1.0 per cent and 1.4 per cent in 2004 and 2005 respectively.

Private consumption remains flat as does private income but business investment has increased significantly. Export volumes fell by 0.4 per cent in the year to June but import volumes increased by 13.3 percent in the same period. Of this most of the increase came from Chinese and ASEAN imports with US imports declining and EU imports remaining flat. Retail sales declined by 0.5 per cent in June but had increased by 1.3 per cent in May. Retail and auto sales have declined again slightly in July. Overseas travel is down but the SARS virus largely explains this. Business investment is up significantly while machine orders, a leading indicator of investment, has been picking up steadily. Housing construction increased by 8.7 per cent in June but public investment is sluggish. The June Tankan survey was encouraging but we expect a better performance in the second half of the year. The index of tertiary activity declined by 0.1 per cent in May on the previous month but the all-activity index increased by 0.2 per cent in the same period.

The all-household survey indicated that real living expenditure increased by 1.6 per cent in the year to June. Unemployment fell from 5.4 per cent in May to 5.3 per cent in June. Unemployment is forecast to be to 5.7 per cent this year and 5.9 per cent in 2004.

Economies hit by the SARS virus are recovering relatively well. Industrial production in China, Korea, Taiwan and Malaysia is increasing significantly.

Kenneth Low
10 September 2003

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